Internal Revenue Service

memorandum

CC:TL-N-7617-90
JCAlbro

date: JUL 12 1990

to: District Counsel, Los Angeles CC:LA
Attn: Margaret Reichenberg

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: [redacted]

This is in response to your request for tax litigation advice dated June 4, 1990, involving a response to taxpayer's Motion for Reconsideration, which is due at the Tax Court on or before [redacted].

ISSUE

Whether the Tax Court's opinion in [redacted], that subscriber deposits were income upon receipt, should be revised in light of Commissioner v. Indianapolis Power & Light Co., 110 S.Ct. 589 (1990). No. 0451-1300.

CONCLUSION

We recommend filing a response to Petitioner's Motion discussing why the court should not revise its opinion, making the arguments as set forth below. It is unnecessary for the opinion to be revised because the result is the same under the Supreme Court's analysis in Indianapolis Power (IP).

FACTS

The Tax Court rendered its opinion in [redacted] and held that under both the Eleventh Circuit's primary purpose test, City Gas Co. of Florida v. Commissioner, 689 F.2d 943 (11th Cir. 1982), and the Tax Court's taxpayer control or facts and circumstances test, City Gas Co. of Florida v. Commissioner, 74 T.C. 386 (1980), the subscriber deposits at issue were taxable income upon receipt. [redacted] later, the Tax Court held in Indianapolis Power & Light v. Commissioner, 88 T.C. 964 (1987), that the customer deposits were nontaxable security deposits and not advance payments. The customers retained substantial rights in the deposits, including the right to determine whether a deposit would be returned or credited against an account. The Seventh Circuit affirmed and stated that a deposit securing an income payment need not always be taxed as an advance payment.

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The deposits were properly excluded from income where interest was paid to customers, and customers controlled the timing of the refund as well as the form of the refund, whether by cash, check or bill offset. Indianapolis Power & Light v. Commissioner, 857 F.2d 1161 (7th Cir. 1988). The Supreme Court opinion affirming the Seventh Circuit, Commissioner v. Indianapolis Power & Light, 110 S.Ct. 589 (1990), was rendered on January 9, 1990.

A final decision in [redacted] is pending the determination of the effect on taxpayers' [redacted] and [redacted] federal income tax liability of foreign tax and other credit carrybacks from the years [redacted] arising from net operating loss carrybacks from [redacted] and [redacted]. That determination, in turn, awaits a review by the Congressional Joint Committee on Taxation of refund claims arising from the recently completed audit of taxpayers' [redacted] and [redacted] federal income tax returns.

On [redacted], taxpayers filed a Motion for Leave to File Motion for Reconsideration of Opinion Out of Time and a Motion for Reconsideration. Believing that the Supreme Court's opinion in IP undermined the legal basis for the Tax Court's opinion in [redacted], taxpayers submitted that the interests of justice warranted consideration of their Motion for Reconsideration. On [redacted], the Tax Court granted taxpayers' Motion for Filing Out of Time and requested the Commissioner to file a response to taxpayers' Motion on or before [redacted].

DISCUSSION

We believe that [redacted] is distinguishable from Indianapolis Power, (IP), and thus it is not necessary for the Tax Court to revise its opinion and conclude that taxpayers are not taxable on their distributive shares of subscriber deposits received by [redacted] ([redacted]). The essential issue, pursuant to the Supreme Court's opinion in IP, is who has ultimate control over disposition of the deposit. Unlike the customer in IP, the subscriber in [redacted] does not exert the requisite control. We will discuss the [redacted] opinion, the Supreme Court opinion in IP, the Service's subsequent position on customer deposits, our response to the main themes in taxpayer's Motion for Reconsideration and why we believe [redacted] is distinguishable from IP.

The stipulations in [redacted] establish that the $[redacted] deposit was collected at the time that the decoder box was installed. (#11). A few days after installation, the subscriber is billed for the first month's charge of $[redacted]. (#13). When subscription television (STV) service was terminated and the decoder box was returned, [redacted] would compute the final amount owing, if any, by the subscriber. If a balance was owing, [redacted] would apply the $[redacted] deposit against that balance and refund the excess to the

subscriber. If no amount was owing, the entire $[redacted] deposit plus any overpayments would be refunded to the STV subscriber.(#14). The deposit was offset in part or in full [redacted]% of the time, and [redacted]% of the time when offset, it was due to an overdue account. See Resp. Reply Brief at 22. Although the theme of taxpayer's brief was that the deposit was security for return of the decoder, the facts clearly established that this was not true. See [redacted]. When [redacted] determined that a decoder box had been lost or stolen by the subscriber, [redacted]'s practice was to bill the STV customer the full amount specified in the liquidated damages clause of the subscription agreement. [redacted] brought many Small Claims Court actions against subscribers who did not return the decoder or pay the liquidated damages amount. Initiation of the Small Claims Court litigation encouraged many of the nonresponsive parties to return their decoder boxes. This litigation also resulted in recovery of money damages.

Paragraph [redacted] of the subscription agreement discusses the "[redacted]", and defines the parameters of the control of the deposit by the taxpayer. "... [redacted]" This paragraph also states that when a subscriber disconnected service, [redacted] would offset the deposit to be refunded for three specific charges: the subscriber's account balance due to [redacted]; repair costs incurred by [redacted] for decoder damage caused by the subscriber, or costs incurred by [redacted] for the subscriber's breach of the subscription agreement. Thus, we argued to the court that [redacted] had absolute unrestricted use and control over the deposit funds.

The deposit portion of the subscription agreement does not state that return of the decoder is a condition of receiving the deposit back. NST's specified recourse if the decoder is not returned is assessment and collection of a $[redacted] liquidated damage amount. The subscription agreement also clearly states (in capital letters) that [redacted] has absolute and unrestricted control and use of the security deposit money and that [redacted] will not segregate or pay interest on the money. This unrestricted, unsecured, interest-free source of funds was critical to [redacted]'s cash flow needs in the early years. If the decoder was not returned, [redacted] billed for liquidated damages and sued to recover decoders. It did not sue to collect receivable balances. Protection for receivables was the deposit, and protection for unreturned decoders was liquidated damages. See Resp. Brief, Points Relied Upon.

The Tax Court held in [redacted], that under either the primary

purpose test of the Eleventh Circuit, see City Gas Co. of Florida v. Commissioner, 689 F.2d 943 (11th Cir. 1982), or the Tax Court's facts and circumstances or taxpayer control test, see City Gas Co. of Florida v. Commissioner, 74 T.C. 386 (1980); IP, 88 T.C. 964 (1987), the deposits were includible in taxpayer's income upon receipt. The court noted that [redacted]'s refund history showed that deposits were intended to be used to offset overdue accounts. Whenever there was a balance due to [redacted] from a subscriber at termination, [redacted] offset the amount due by the $[redacted] deposit. The deposit was actually used to offset subscriber accounts for [redacted]% of the accounts. Furthermore, for financial accounting purposes, [redacted] treated the deposits as though they were to be applied to accounts that paid for services and rent on the decoders rather than to be used to secure the safe return of the decoders. The court quoted from paragraph 6 of the subscription agreement, and concluded that [redacted] had control over the deposits upon receipt. [redacted].

In IP, the Supreme Court applied a facts and circumstances test to determine whether the taxpayer had unfettered dominion and control over the funds. The Court found unfettered dominion and control lacking, emphasizing that customers controlled the mechanics of whether deposits were refunded or credited to bills and that IP had no guarantee that it could keep the deposit because customers had made no commitment to purchase any electricity. The Court recognized that IP derived some economic benefit from the deposits but that it did not have the requisite complete dominion over them at the time they were made. IP had an obligation to repay the deposits upon termination of service or satisfaction of the credit test. Also, customers made no commitment to purchase any electricity; thus, while deposits eventually could be used to pay for electricity by virtue of customer default or choice, IP's right to retain the deposits at the time they were made was contingent upon events outside its control.

To the Supreme Court, control over the funds is the dispositive factor; for an amount to be a taxable advance payment, a payor cannot have control over its disposition. To be taxable, the recipient's retention of the amount must be subject only to its performance of its contractual obligation. In IP, the customers had control over the disposition of the deposits. They could decide not to purchase electricity and could elect to have the deposit either credited to their accounts or refunded. Since IP did not have control over its continued retention of the deposits, they were not advance payments. "The key is whether the taxpayer has some guarantee that he will be allowed to keep the money." 110 S.Ct. at 593. IP had no such guarantee; rather it was obligated to refund the deposits if the customers met their contractual obligations.

We believe that in [redacted] the degree of customer control as in

IP is lacking. IP's right to keep the money depended upon the customer's purchase of electricity and upon a later decision by the customer to have the deposit applied as a payment or directly refunded. In [redacted], the disposition of the deposit was solely within the payee's control. That is, the subscription agreement, para. [redacted], [redacted]. Even if a customer paid regularly, payee could offset the deposit upon disconnection ("[redacted]"). Thus, we believe that the subscription agreement provisions satisfy the Supreme Court's requirement that the taxpayer have a guarantee that it can keep the money. An individual who makes an advance payment retains no right to insist upon return of the funds. 110 S.Ct. at 595. This is true in [redacted]; the subscriber has no right to request a refund.

Pursuant to IP, Service position is that if a customer making a deposit is at that time contractually obligated to purchase the item for which the deposit secures payment or the recipient has the option to apply the deposit as satisfaction of an amount of income arising later, the deposit is an advance payment taxable upon receipt. See J. and E. Enterprises, Inc. v. Commissioner, T.C. Memo. 1967-191, infra. If the payor does not have control over the deposit and the payee has some guarantee that he may keep the deposit provided that he performs, the deposit is income to the payee. In any case in which the payor and the payee contract to buy/sell a predetermined amount of service/goods and the payor deposits a sum to secure his performance and the deposit may, at the payee's option, be used to satisfy all or part of the purchase price, it should be argued that the deposit is an advance payment to the payee. Once the deposit is made, the payor no longer has any control over it as long as the payee performs. Under this analysis, the deposits in [redacted] are taxable advance payments.

Taxpayer's Motion for Reconsideration alleges that IP undermines the basis for the Tax Court's opinion in [redacted]. The motion has two main themes. First, it alleges that [redacted] had no more control over the ultimate disposition of the deposits than IP had over the customer deposits involved in that case. We contend, of course, that this is not true. Pursuant to the subscription agreement, the taxpayer in [redacted] retained control wholly different in character from the limited control exercised by IP. Secondly, taxpayer again argues that the deposit served a bona fide property protection purpose. As noted, supra, this was essentially taxpayer's only argument on brief. The Tax Court specifically found that there was no decoder property protection interest involved with the deposits. "... [redacted]".

[redacted] is distinguishable from IP both with respect to the control over the disposition of the deposits and because of the

close analogy between [redacted] and various rent deposit cases.

With regard to the control issue, we believe that it is important to emphasize that the Tax Court, in applying its own facts and circumstances or taxpayer control test, made a factual finding that [redacted] had control over the subscriber deposits upon receipt. [redacted]. In making such a finding, the Court relied on paragraph [redacted] of the subscription agreement. Furthermore, there are other distinguishing factors in [redacted] which are related to the control issue. The Tax Court specifically noted in [redacted] that unlike utilities, whose use of customer deposits is restricted by state regulation, the taxpayers in [redacted] had unfettered control over the deposits. [redacted]. Also, [redacted] subscribers cannot demand refunds. The contingency relied on by the Supreme Court of the customer choosing not to purchase any services after paying a deposit does not exist. See 110 S. Ct. at 594. Here, there is a contract and an installation of service when the deposit is paid. See installation agreement. Upon receipt of the deposit, taxpayer has unrestricted control and the option to apply the deposit as satisfaction of an amount of income due later. These factors, of course, are supported by the actual use of the deposit as account offsets as agreed to in the stipulations.

It is also worth noting that [redacted] months after rendering its [redacted] opinion, the Tax Court, in IP, 88 T.C. at 978 fn.6, discussed the facts of [redacted] which were different from IP and which it found persuasive to its holding that the [redacted] deposits were advance payments. The court stated that unlike in [redacted], "... [redacted]." Id.

Four rental deposit cases are relevant to the instant issue. J. and E. Enterprises Inc. v. Commissioner is discussed in the body of the IP opinion, and the Court stated, 110 S.Ct. at 595, fn. 9, that three particular rental deposit cases distinguish between advance payments and security deposits.

J. and E. Enterprises Inc. v. Commissioner, T.C. Memo. 1967-191; 26 TCM(CCH) 944, is the only rental deposit case discussed in the body of the IP opinion. The Court cited to J. and E. stating that its decision "is also consistent with the Tax Court's longstanding treatment of lease deposits-perhaps the closest analogy to the present situation." IP, 110 S.Ct. at 595 and fn. 9. The Tax Court's longstanding treatment of lease deposits is that a sum designated as a prepayment of rent is

taxable upon receipt and a sum deposited to secure the tenant's performance of a lease agreement is not. Id.

The lease in J. and E. provided that the security deposit secured payment of rent due and that the security at lessor's option would either be repaid to lessee or applied to the fixed annual rental. Respondent's position was that the deposit was advance rental income. The Tax Court stated that if a sum is received by a lessor at the beginning of a lease, is subject to his unfettered control, and is to be applied as rent for a subsequent period during the term of the lease, such sum is income in the year of receipt even though in certain circumstances a refund thereof may be required. If on the other hand, a sum is deposited to secure the lessee's performance under a lease, and is to be returned at the expiration thereof, it is not taxable income even though the fund is deposited with the lessor instead of in escrow and the lessor has temporary use of the money. The acknowledged liability of the lessor to account for the deposited sum on the lessee's performance of the lease covenants prevents the sum from being taxable in the year of receipt. See also IP, 110 S.Ct. at 595, fn. 9. The Tax Court then noted that the question of which rule is applicable must be resolved by reference to the intention and conduct of the parties as ascertained from the lease agreement and related circumstances.

In essence, because the lessor had the option in J. and E. to apply the funds to rent or to make a refund, the deposit was held taxable income. The Tax Court stated that the lease placed no restriction on taxpayer's use or disposition of the sum. The money was not segregated and interest was not paid. The circumstance of repayment was within the exclusive control of the taxpayer--he had the option to return the deposit or to apply it to rent. The deposit received at the beginning of the lease "was subject to its unfettered use and control and, at its option, was to be applied on the rent due for a subsequent period. Its predominant characteristics were those of advance rent, not security deposits." J. and E., 26 TCM (CCH) at 946.

In footnote 9, 110 S.Ct at 595, the Supreme Court noted that Gilken Corp. v. Commissioner, 176 F.2d 141 (6th Cir. 1949); Hirsch Improvement Co. v. Commissioner, 143 F.2d 912 (2d Cir. 1944) and Mantell v. Commissioner, 17 T.C. 1143 (1952) distinguish between advance payments and security deposits.

In Gilken Corp. v. Commissioner, 176 F.2d 141 (6th Cir. 1949) (to be applied as rent, subject to contingencies), the Tax Court held that $8,200 received by taxpayer from lessee as advanced rent, security for performance of covenants and as part of the purchase price of the leased property, should lessee exercise its option to buy, was income upon receipt.

The lease clauses at issue provided that the $8,200 deposit was security for full performance by lessee of obligations under the lease and was to be applied upon the last two months of the last year's rent accruing under the lease provided lessee was not in default of any terms. If the lessee exercised an option to purchase the property, the deposit would be applied as credit toward the purchase price.

The court decision noted that the $8,200 was paid without any restriction on the use of the money, and it was not set aside in trust or in escrow. Citing to the claim of right doctrine, North American Oil v. Burnet, 286 U.S. 417,424 (1932), the court held that the deposit was taxable income in the year of receipt. Taxpayer had free and unrestricted use, enjoyment and disposition of the advance rental payments, and no interest was paid. Return of the money was required only upon the contingency of lessee's exercise of the option to buy or upon the contingency of lessee defaulting in performance of lease conditions. In the court's view, neither contingency changed the character of the payment from advance rent, which was subject to taxpayer's unrestrained control.

Hirsch Improvement Co. v. Commissioner, 143 F.2d 912(2d Cir. 1944) (prepaid rent) involved $35,000 paid as security for the payment of rent and the performance of lease covenants and conditions. The lease stated that the lessor shall apply such sum to the last year of the lease except that in the event of default in rent payment or default in performance of covenants and termination of the lease, the security shall be retained in payment of damages by reason of the termination and default. The lease provided that unearned advance rent would be refunded upon the occurrence of two events--if the premises were destroyed and could not be rebuilt within six months or upon condemnation.

The Commissioner's position was that the $35,000 was taxable rental income. The court agreed, relying on two major factors. First, taxpayer had no obligation to segregate the payment, and the only possibility of repayment to the lessee was upon severe damage to the premises or upon condemnation--circumstances which might never occur and insufficient to require that the sum be categorized as not intended as rent. "Where the taxpayer has virtually unrestricted control over the amount deposited and does not pay interest on such amount, the amount has been considered an advance payment of income," Indianapolis Power & Light v. Commissioner, 88 T.C. 964, 976 (1987) (citing Hirsch).

In Mantell v. Commissioner, 17 T.C. 1143 (1952) (security for performance and not to be applied as rent), the Tax Court disagreed with respondent's determination that a payment upon execution of a lease was paid in prepayment of rent rather than as a security deposit. Pursuant to the lease, the deposit was security for performance of all lease conditions, security for

return of the leased property, to indemnify the lessor against any damages to the premises, as well as any damage on account of any breach of the lease. There was an acknowledged liability to return the security fund at a future date. Furthermore, the lease stated that the security deposit was not to be applied as rent and that lessor was not required to pay interest or keep the money in a separate account.

The court cited to Hirsch and noted that if under a present claim of full ownership and subject to lessor's unfettered control, a payment is to be applied to the rent for the last year of the term, it is income even though under certain circumstances a refund may be required. If on the other hand, the sum was deposited to secure the lessee's performance under the lease, it is not taxable income even though the fund is deposited with the lessor and not in escrow and the lessor has temporary use of the money. The court acknowledged that sometimes a deposit serves both as security for performance and if any or all of it remains during the final period of the lease, it is to be applied to rent. It then becomes necessary to determine whether the deposit was primarily a security payment or a prepayment of rent. This question of fact is resolved by reference to the intention and acts of the parties ascertained from the lease agreement and the relevant circumstances. (With regard to [redacted], the preponderance of the facts supports a finding that the payment was primarily a prepayment. Our brief argued persuasively that the deposit was not the means for securing the return of the decoder. Also, [redacted]% of the time, all or part of the deposit was applied as an offset to amounts owed.) The Mantell deposit was clearly a security payment. The lease expressly provided that the deposit was not to be applied to rent.

We believe that it is also important that, in [redacted], the payee was not obligated to pay interest on the payments at issue. Although this factor was not discussed by the Supreme Court in IP, it was of particular significance both to the Tax Court and to the Seventh Circuit. The Tax Court in IP stated that taxpayer treated the deposits as belonging to customers. Customers were given a receipt and received interest. The deposits were accounted for as current liabilities. The court believed that the payment of interest and the accounting treatment made the deposits more like loans than advance payments. 88 T.C. 964, 977-78 (1987). The Seventh Circuit noted that the value of a deposit is related either to a return factor or a security factor. When a reasonable rate of interest is paid on a deposit, the value of the deposit to the depositee may relate predominantly to the security factor which comports more squarely with the common sense definition of a security deposit. 857 F.2d 1162, 1168-69 (7th Cir. 1988). The Seventh Circuit also stated that the payment or nonpayment of interest on a deposit is a very important factor in analyzing the facts and circumstances. 857 F.2d 1170, fn. 12. The court further indicated that the presence

or absence of the payment of interest substantially reconciles the line of cases addressing the taxability of customer deposits. See 857 F.2d 1169,fn. 11. Thus, the payment of interest may be viewed as a factor to consider in determining who truly has control over the deposit.

We believe that in [redacted] the payee had control and a guarantee that the deposits could be kept, which the payee did not have in IP. Furthermore, there is a closer analogy to the prepaid rental cases than to the utility deposits at issue in IP. In J. and E., for example, taxpayer had the unilateral option to determine how the deposit would be used. We believe that paragraph six of the subscription agreement, read in its entirety, places any return of the deposit at payee's option and subject solely to payee's control.

If you have any further questions, please contact Joyce C. Albro, at 566-3442.

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